THOMAS MILLER INVESTMENT

Investment Commentary

JUNE 2014

US economic developments

Revised data published at the end of May showed that US real GDP contracted by 1% during the first quarter, marking the first decline since Q1 2011 and only the second contraction since the recession officially ended in mid-2009.

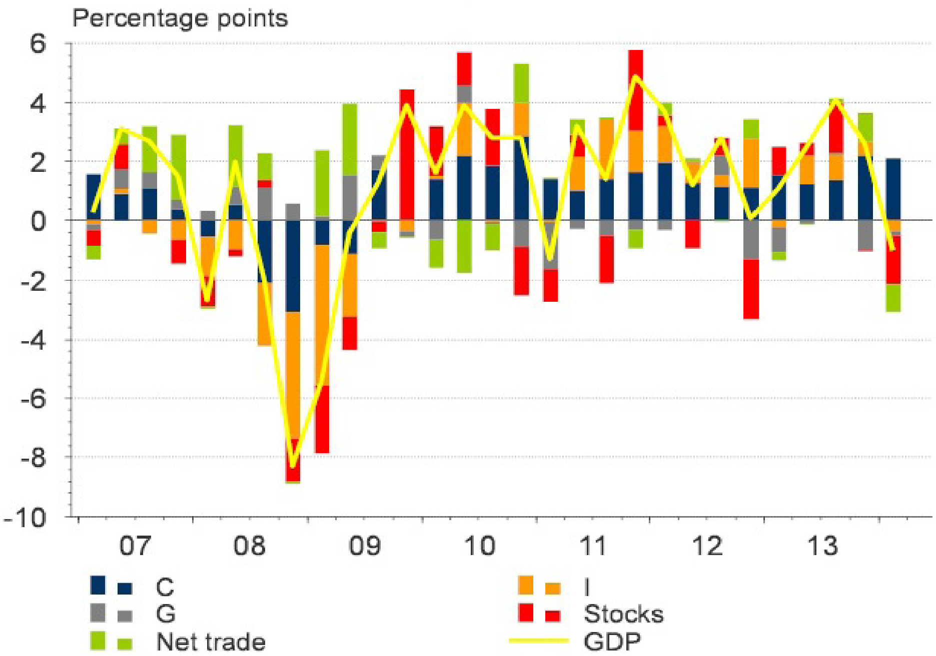
Although the fall in contributions from business investment, net trade, local and state government spending, and housing investment all added to the decline, the principal driver of the contraction in first-quarter real GDP was a fall in the contribution from inventories, which subtracted 1.6 percentage points from GDP.

Looking ahead, we expect a pick-up in the pace of growth over the remainder of the year. Indeed, real final sales of domestic product (i.e. GDP less inventory investment) rose 0.6% in the first quarter, indicating that underlying economic activity continues to grow—albeit at a modest rate. Furthermore, it is encouraging that a broad range of activity surveys have posted strong readings in recent weeks. Likewise, leading economic indicators remain positive and optimism among small business owners is currently running at multi-year highs. All these point to stronger growth in the months ahead.

Global economic roundup

Beyond the US, growth continues at a steady pace across the major developed economies. OECD composite leading indicators point to stable growth momentum in the OECD area and a positive change in momentum in the Euro area. Data on the Japanese economy has also been stronger than expected in recent weeks. However, leading economic indicators for the major emerging markets continue to signal below trend growth rates. Nevertheless, there are encouraging signs that the tide may be turning for some of the major emerging economies. For instance, recent reports have provided evidence that the Chinese economy is stabilising, with a recovery in manufacturing being supported by targeted monetary policy stimulus. Elsewhere, in India, the recent election victory of prime minister Narendra Modi has fuelled hopes of a turnaround in the economy.

Chart 1: Contributions to GDP Growth



Source: Thomson Reuters Datastream / Fathom Consulting

Note: C = Consumer spending; G = Government expenditure; I = investment.

In the UK, consumer spending, retail sales, business investment and industrial production have all grown at brisk rates in recent months. Additionally, the labour market continues to strengthen while inflation continues to drift lower. All these have enabled the Bank of England to maintain a loose monetary policy stance despite the increasing clamour for rate hikes by various commentators. Market consensus is for the first rate hike by the MPC to come in April 2015. This is broadly in line with our expectation that the first hike should come no earlier than the second quarter of 2015.

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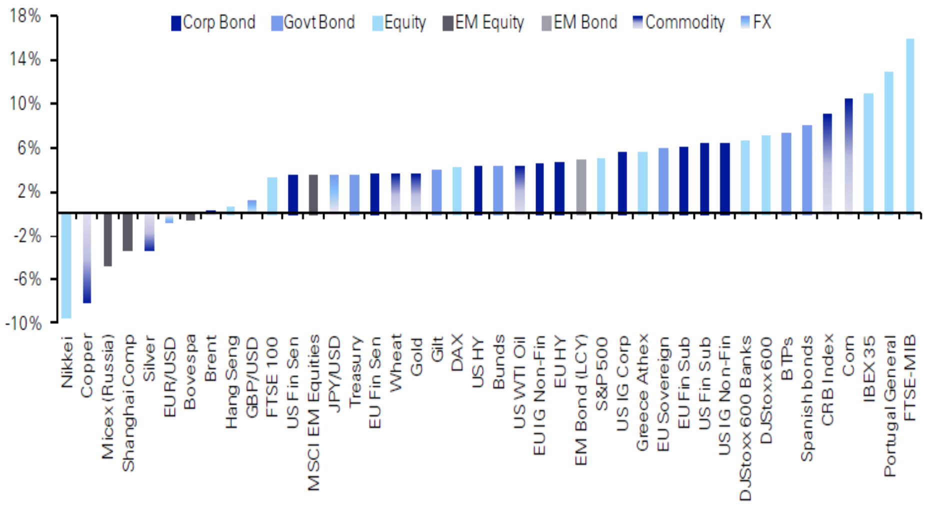
In our view, assertions that the MPC needs to raise interest rates now in order to prevent a house price bubble miss a number of important points. Clearly, the housing market is a key driver of the UK economy. However, in the absence of signs of overheating in the broader economy, interest rate hikes would be misguided. Raising the interest rate is a rather blunt tool and officials have at their disposal, tools that can be more precisely targeted at the housing market. These include tighter controls on a number of important variables such as loan-to-value ratios, mortgage lending and underwriting standards. Moreover, the recent back-to-back declines in mortgage approvals may signal an impending cooling in the property market.

Financial markets overview

Chart 2: Total returns so far in 2014 (Local Currency Terms)



Source: Deutsche Bank, Markit, Bloomberg Finance LP

During May, equities gradually climbed higher, with the S&P 500 index gaining about 2.3%. The UK's FTSE All Share index was up about 1.4%, while Germany's DAX returned about 3.5% (all total returns in local currency terms). Emerging market equities also did well, and the MSCI Emerging Markets Index outperformed the MSCI World Index by some 30 basis points over the course of the month. Russian equities did particularly well, with gains of close to 10% as investor sentiment improved. Indian equities also recorded strong gains as investors anticipated a programme of economic reforms following the election of prime minister Modi.

Fixed income markets continued the positive trend since the start of the year. As with equities, performance within the asset class was led by Emerging markets (the JPMorgan EMBI+ Index delivered total returns of 3.1%). Bond yields also fell (and bond prices rose) across the US, UK and Euro-zone. For instance, over the month, yields on 10-year government bonds fell by 17, 9 and 11 basis points in the US, UK and Germany respectively.

The rally in government bonds so far this year has caught many investors by surprise. Most investors were positioned for a gradual rise in bond yields primarily in expectation of stronger economic growth. However, growth has been weaker than expected and this has led to a rise in fund inflows into the asset class. Also, on the supply side, the volume of bond issuance has fallen so far this year.

Looking ahead to the rest of the year, while there are pockets of relative strength (such as the UK and, more recently, Japan), we expect economic growth to remain modest and core inflation to remain benign across the developed economies. Consequently, any push up in government bond yields from current levels will likely be minimal—at least until the pace of economic growth picks up notably. For equities, we continue to believe that the backdrop of steady, albeit slow, global economic growth; moderate inflation; decent corporate earnings; and accommodative monetary policy can support mid to high single-digit rates of return. However, future equity returns are likely to come in the context of higher market volatility. This is because we consider the current situation of extremely low equity market volatility (as proxied by the VIX) to be unsustainable.

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Monetary policy divergence

Following its meeting in June, the ECB announced a range of monetary policy stimulus measures including the decision to cut both the main refinancing and deposit rates. The ECB's decisions had been widely anticipated in the markets. Indeed, in recent weeks, government bond yields in the Eurozone had fallen to multi-year lows, driven by a combination of falling inflation and rising expectations of such monetary stimulus measures by the ECB. Overall, these measures should support the downward trend in bond yields while also boosting European equities. In the currency markets, we expect the euro to remain under selling pressure. As we have noted in the past, the best way to exploit this 'weak euro' expectation is against the sterling.

More broadly, monetary policy divergence will remain a dominant theme for markets for some time. This is because, unlike the Bank of England and the US Federal Reserve Bank which are widely expected to begin raising interest rates next year, the economic backdrop in the Euro-zone should mean that the ECB maintains a loose monetary policy stance for the foreseeable future.

Investment strategy summary

Nothing has happened in recent months to change our view that equities remain the asset class of choice for long term investors. In the shorter term though, we still consider it prudent to be somewhat cautious on risk assets. Within equities, we favour overweight positions in the UK, Euro-zone and Japan. In the fixed income markets, we continue to prefer corporate bonds to government bonds. In the currency markets, we have moved to underweight position in the Euro (against both the US Dollar and sterling).

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